Evenlode Investment View

February 2015 - Risk Management in a Rising Market

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INVESTMENTS FOR LIFE

European markets, including the UK, have performed strongly in the first six weeks of the year. The UK market, as I write, is up +5.9% (Evenlode is up +5.5%)*. Perhaps the most obvious reason for this recent rally is the European Central Bank (ECB)'s efforts in January to fight the looming threat of deflation in the eurozone, by launching a new programme of quantitative easing (QE). In doing so the Europeans, along with the Japanese, have taken over the money-printing baton from the Americans who halted their QE programme in October last year.

Whether this policy will have a meaningful effect on the real-world European economy remains to be seen.

What the announcement *did* help do effectively in January was push both government and corporate bond yields to ever lower levels, and though yields have risen somewhat in February, the lack of return from cash and bonds is clearly helping to drive stock markets higher. The yield on one of Nestle's bonds turned negative at the beginning of February. This is quite something. To pay for the privilege of lending a company money is breaking new ground in financial history. But then, if you are a Swiss citizen, a yield of -0.008% on Nestle's four year bond compares very favourable to the -0.75% interest rate available at the bank.

European investors might begin to wonder whether stashing their savings under the mattress is a more sensible way to proceed.

The Best House In a Bad Neighbourhood

An alternative to the mattress, of course, is the stock market. And the *relative* argument for stocks is clear. They remain the 'best house in a bad neighbourhood'. Starting dividend yields of 3-4% for sensible companies are still available across European markets, including the UK. These yields do not stand out on the slide rule of long-term history, but they *do* stand out as an oasis in the desert of yields available on cash and bonds. They also have the potential to protect investors from inflation if and when it picks up again – neither of which is something cash and bonds can deliver. And it's worth holding the thought that it's *inflation*, rather than Mr Market's current worry of *deflation*, that is the normal state of affairs. Over the last hundred years, the UK inflation rate has averaged +4%. Since 1971, when global currencies relinquished their link to gold with the end of the Bretton Woods era, UK inflation has averaged more than +6%. To put it another way, £100 stashed under a British mattress in 1971 would now be worth less than £10 in today's money.

Shares in good businesses represent the fractional ownership of goods and services that society habitually desires, which gives them pricing power. This is comforting in a world where central banks are in a race-to-the-bottom competition to depreciate their currencies: whatever the price level, people will still attribute value to products such as vaccines, toothpaste, shampoo, ice cream, soft drinks, beer, accountancy software, academic journals etc.

The Risk of Overpaying For Great Businesses

Despite the above attractions of shares, it is an unavoidable fact that valuations are rising, and a strong bull market is like a bucket of cold water on the prospect of generating future returns. While we are big advocates of owning cash generative businesses with pricing power over the long run, *even the best business is not a good investment if the starting valuation is too high*.

Our valuation discipline tends to result in us moving in the opposite direction to the crowd. In 2012-13 we moved towards larger, more stable businesses that were underperforming a risk-taking market hungry for smaller stocks. This benefited our performance in 2014 as the market became more risk adverse.

More recently, we have been (for us anyway!) quite active in terms of making changes to the portfolio, mainly just driven by volatility in individual shares. Many larger, more stable businesses have performed extremely well over the last year. Since last summer we have sold our holdings in Novartis and Smith & Nephew, and have significantly reduced our holdings in Reckitts, SABMiller, Reed Elsevier and Compass. We have also added nine stocks to the portfolio since last summer and added significantly to several existing holdings on share price weakness**. These new holdings fulfil our quality criteria, and offer good potential for long-term dividend growth. But they have been out of fashion recently for various reasons, which has improved valuations. Several of the names in the list are smaller business models - it has been nice to return to this area of the market more meaningfully again.

As an aside, and because we have been asked the question rather a lot recently, it's worth mentioning that we are still comfortable with Unilever's valuation (the fund's largest holding). Following the share's price spike at the start of the year we did begin trimming our position (though we are long-term investors we do incrementally reflect valuation changes in position sizing). However, our estimate of Unilever's forward cash return still looks very attractive, as does the 3.5% starting dividend yield.

As the year progresses we will, as always, remain open to taking advantage of volatile share prices.

The Risk Of Buying 'Cheap' Businesses

In my view, the risk of reaching too far down the quality spectrum in search of returns is *just* as significant as the risk of overpaying for a great business in the current market. 'Cheap' stocks don't always turn out to be cheap. Headline 'value' (e.g. a low price to earnings (PE) multiple on this year's earnings or a high stated dividend yield) can prove illusory for companies where free cash flow and therefore dividends prove unsustainable under duress – particularly for those companies relying on weak balance sheets to generate their current returns***.

Economic conditions remain tough, as they have done for the last six, post-crisis years. Revenue growth is hard to find in global and domestic economies that are bumbling along. Sharp moves in currencies are also creating uncertainty for UK-listed multinationals. Though the recent fall in the oil price is likely to present a good cyclical boost to global growth in coming months, the latest company results season is a reminder that many corporates are experiencing pressure on their cash-flows (in some areas, such as the oil sector, severe pressure). Debt levels are ticking up. Companies are desperate to continue paying their dividends, but this has become increasingly difficult for some - UK dividends barely grew in aggregate for 2014. With this backdrop, companies risk underinvesting in their longer-term growth.

To sum up, the potential returns on offer in today's market are declining as valuations rise. And fundamental risks remain high. We are picking our way through carefully, looking 'down' at the risks as well as 'up' at the returns. A focus on sustainable free cash flow is more important than ever. Healthy cash generation acts as a safety buffer when times get difficult – whether due to a downturn in the overall economy, a company's industry, or stock-specific issues. And it allows for continued investment in long-term growth opportunities, even through adversity.

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Please note, these views represent the personal opinions of Hugh Yarrow as at 20th February 2015 and do not constitute investment advice.

*B Acc shares, total return net of fees. Source: Financial Express
**New holdings include Spectris, IMI, Informa, Paypoint, PZ Cussons, WS Atkins, MITIE, Wolters

Kluwer and Sanofi.
***Something that isn't always discussed when headline measures such as PE multiples are used as a benchmark of value is *how much of the perceived 'cheapness' is being created by leverage*?
We always look at this issue as part of our valuation process. We estimate long-term cash flows and compare them to the stock's *enterprise value* as well as the market capitalisation. Enterprise value is what a private buyer would use to analyse a business and adjusts for the level of net debt. All things being equal, we would rather invest in a company with a strong balance sheet and a higher PE multiple than one with a weak balance sheet and a commensurately lower PE multiple.